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ABSTRACT

This report presents findings of an investigation of the use of federal research and development grant funds by the University of California system in its payments to graduate student researchers (GSRs). Specifically, the study examined whether: (1) compensation paid to GSRs was in accordance with guidelines of the Office of Management and Budget; (2) foreign GSRs were receiving a larger share of federal research funds than resident GSRs; (3) the university's treatment of GSR compensation for federal income tax purposes was consistent with charging such money to federal grants; and (4) oversight provided by the Department of Health and Human Services (HHS) was adequate. Relevant findings indicated: (1) the university charged federal sponsored research $19.3 million for compensation in excess of what it paid first-level postdoctoral researchers for comparable work; (2) foreign GSRs received a larger proportionate share of total tuition and fee remission costs charged against federal grants than did resident GSRs; (3) no conclusion could be reached concerning proper tax treatment of tuition remission provided to GSRs; and (4) HHS ensured that the institution had not requested GSR compensation to exceed certain caps. A letter from the Internal Revenue Service explaining tax treatment of tuition remission is appended. (DB)

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ED 432 948

United States General Accounting Office

GAO

Report to the Chairman
Committee on Commerce
House of Representatives

June 1999

FEDERAL RESEARCH GRANTS

Compensation Paid to Graduate Students at the University of California

I-IE 032 256

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United States General Accounting Office
Washington, D.C. 20548

Office of Special Investigations

B-282325

June 22, 1999

The Honorable Thomas J. Bliley, Jr.,
Chairman, Committee on Commerce
House of Representatives

Dear Mr. Chairman:

This letter responds to your May 1, 1998, request and subsequent discussions with your office that we investigate the use of federal research and development grant funds by the University of California system in its payments to graduate student researchers (GSRs). The University of California is one of the leading research universities in the United States. In fiscal years 1996, 1997, and 1998, the university charged approximately $201 million against federal research grants for GSR compensation. You asked that we determine if

- the compensation paid to GSRs was in accordance with the guidelines set forth in the Office of Management and Budget's (OMB) Circular No. A-21, "Principles for Determining Costs Applicable to Grants, Contracts, and Other Agreements With Educational Institutions";
- foreign students were receiving a larger share of federal research funds than resident students as compensation for performing as GSRs; and
- the university's treatment of GSR compensation for federal income tax purposes was consistent with its actions in charging such moneys to the federal grants under OMB Circular No. A-21.

In addition, you asked us to review the adequacy of the oversight provided by the Department of Health and Human Services (HHS) in safeguarding against the diversion of funds from federal research grant awards.

Results in Brief

OMB Circular No. A-21 (July 1993)[1] establishes the principles to be applied in determining allowable costs for research and development, training, and other sponsored work performed by colleges and universities under grants,

[1]The version of OMB Circular No. A-21 issued in July 1993 is applicable for the period we investigated. The circular was revised in Oct. 1998, but no substantive changes regarding the issues discussed in this report were made.

contracts, and other agreements with the federal government. It allows universities and colleges to charge to federally sponsored programs "... tuition remission and other forms of compensation paid as, or in lieu of, wages ..." to GSRs on those programs, provided that (1) there is a bona fide employer-employee relationship and (2) the tuition remission or other payments are reasonable compensation for the work performed and conditioned explicitly upon the performance of necessary work. It must also be a university's practice to similarly compensate students in nonsponsored activities.

GSRs receive a salary and tuition and/or fee remission from the University of California as compensation for their work on federally sponsored research projects. According to the university, its practice of charging the salary and remissions against federally funded research grants complies with OMB Circular No. A-21. However, based on our review of the compensation paid to GSRs for services charged to federal research grants, we found that these payments sometimes exceeded the allowable costs that could be charged to such grants.

We compared the compensation paid to individual GSRs assigned to federally sponsored research projects against (1) the National Institutes of Health (NIH) guideline that establishes an award level of $23,000 per GSR and (2) the salary of a first-level postdoctoral researcher at the university performing comparable work at an equivalent level of effort. Of the $201 million charged by the university to federally sponsored research during school years 1995-96 through 1997-98, $4.4 million was charged in excess of the NIH maximum award in what we believe to have been unreasonable compensation. The university also charged federally sponsored grants approximately $19.3 million for GSR compensation that exceeded the salary of a first-level postdoctoral researcher during the same period.

Although all GSRs receive substantially the same salary for work performed on federal research grants, foreign students receive a proportionally larger share of fee and tuition payments charged to the grants because they pay a higher nonresident student tuition. While representing 21 to 24 percent of the GSRs at the university in school years 1995-96, 1996-97, and 1997-98, foreign students received 34 to 38 percent, for a total of $13.9 million, of the $38.6 million charged to federal research grants for tuition and fee remission.

Although the university treats GSRs' salary and tuition and/or fee remission as compensation for purposes of the OMB circular, traditionally it has treated only the salaries as part of the GSRs' gross income for federal income taxes. The university excludes all tuition and fee remission from gross income as qualified remission, asserting that this practice is in accordance with Internal Revenue Code section 117(d). When we asked the Internal Revenue Service (IRS) for its views of this practice, IRS informed us that, as a general principle, reasonable tuition remission provided as a result of an employer-employee relationship can properly be considered a fringe benefit and excludable from the employee's gross income for tax purposes. IRS explained that the treatment of the compensation by the employer under OMB Circular No. A-21 is not relevant to its determination of the tax consequences of the compensation under the Internal Revenue Code. Similarly, HHS and NIH officials told us that in determining whether tuition remission is allowed under the grant, they pay no attention to the taxability issue. A district court case is pending against the University of California in which the relator[2] has asserted False Claims Act violations by the university for its treatment of the tuition remission paid to GSRs under the OMB circular. In view of this pending case and the HHS and NIH opinions, we do not address in this report whether the tuition remission provided to GSRs should have been taxed or whether the university's treatment of the tuition remission for tax purposes is consistent with the OMB circular.

As the cognizant audit agency for the University of California, HHS does not routinely conduct preaward or postaward audits. When audits are conducted in response to specific requests for awarding agencies other than NIH, HHS determines only whether line-item amounts exceed the amounts approved by the awarding agencies. When auditing NIH awards, HHS follows the same action except with respect to the specific costs involving GSR compensation. For these costs, it ensures that the institution has not requested GSR compensation that would exceed the NIH cap of $23,000 (now $26,000) per GSR identified in the request. HHS relies on the respective universities to ensure that compensation paid to GSRs is reasonable and does not exceed the established guidelines.

[2]A relator is the person on whose complaint, or at whose instance, certain writs are issued.

Background

Since World War II, the federal government has been a key supporter of research activities at universities and is the leading source of funding for academic research and development in the United States. Its involvement has been generally viewed as beneficial to the university community as well as to the nation as a whole. Each year, the Department of Defense, the National Science Foundation, NIH, and other departments and agencies of the federal government provide universities with billions of dollars for basic and applied research under federal grants. The universities in turn use these funds to pay the costs of the research, including the salaries of professors and GSRs.

OMB Circular No. A-21 (July 1993) establishes the principles to be applied in determining allowable costs for research and development, training, and other sponsored work performed by colleges and universities under grants, contracts, and other agreements with the federal government. It applies to compensation provided by colleges and universities to graduate students who work on federally sponsored research projects at those institutions.

The OMB circular states that tuition remission and other forms of compensation, paid as or in lieu of wages, to students performing necessary work are allowable provided that (1) a bona fide employer-employee relationship exists between the student and the institution for the work performed, (2) the tuition or other payments are reasonable compensation for the work performed and conditioned explicitly upon the performance of necessary work, and (3) it is the university's practice to similarly compensate students in nonsponsored, as well as sponsored, activities.[3]

OMB Circular No. A-21 applies a "prudent person" test in determining whether the compensation is reasonable. It provides that in determining reasonableness, major considerations are (1) whether or not the cost is of a type generally recognized as necessary for the operation of the institution or the performance of the sponsored agreement; (2) the restraints imposed by such factors as arm's length bargaining; (3) whether or not concerned individuals acted with due prudence in the circumstances, considering their responsibilities to the institution, its employees, its students, the

[3]Id. ¶ J.11.a.

government, and the public at large; and (4) the extent to which the actions taken are consistent with established institutional policies and practices.[4]

In an October 1994 audit report of GSR compensation charged to NIH awards at four selected (non-California) universities, the HHS Office of Inspector General (OIG) noted that the OMB circular did not provide clear guidance on reasonable compensation to graduate students. The OIG recommended that the HHS Assistant Secretary for Management and Budget work with OMB to provide guidance on the standard of reasonableness for graduate student compensation.[5] To date, the HHS Assistant Secretary has not made a formal request to OMB concerning this issue, and OMB has not issued additional guidance on the reasonableness standard.

However, following the HHS OIG report, NIH issued new guidelines in May 1995 that related to the determination of reasonable compensation for GSRs employed on NIH research grants. As in the past, the guidelines provided that NIH would continue to consider compensation for personal services of GSRs rendered on an NIH research project to be allowable so long as the compensation (1) is reasonable, (2) conforms to the established consistently applied salary and wage policies of the institution, and (3) reflects the percentage of time actually devoted to the funded project. However, according to the guidelines, reasonable compensation for GSRs could not exceed the amount allowable for a first-level postdoctoral researcher performing comparable work at the same institution.

On January 26, 1996, NIH amended its guidance. It reiterated that NIH would continue to consider compensation for personal services of GSRs as employees on NIH research projects to be allowable so long as the compensation is reasonable. The guidance also stated that in no case should the total compensation package for GSRs exceed that of a first-level postdoctoral researcher at the same institution. NIH noted that its National Institute of General Medical Sciences generally provides total compensation of $20,000 to $23,000 to GSRs employed on research grants. In March 1996, NIH issued additional guidance, stating that, if reasonable, it

[4]Id. ¶ C.3.

[5]The OIG utilized the starting salary of a first-level postdoctoral researcher at each university as a measure of reasonableness for that university. The OIG estimated that three of the four universities it studied had charged federally sponsored research about $5.7 million in unreasonable GSR compensation.

would award the actual amount requested for GSR compensation, up to a maximum of $23,000. The guidance further provided that recipients could rebudget funds to charge more than $23,000 to the grant award, provided that it was in accordance with OMB Circular No. A-21. NIH explained, however, that the amount could not exceed the amount paid to a first-year postdoctoral researcher doing comparable work at the same institution. On December 4, 1998, NIH raised the cap to $26,000. As with the earlier guidance, it permitted institutions to rebudget funds to charge more than $26,000 to the grant award, provided the amount does not exceed the amount paid to a first-year postdoctoral researcher performing comparable work at the same institution.

Compensation for GSRs

As one of the leading research universities in the United States, the University of California receives funding controlled by individual agreements between federal award agencies and representatives of the university.[6] Annually, approximately 38,000 graduate students are at the university, about 7,000 (18 percent) of whom are doctoral degree candidates. With few exceptions, it is the 7,000 doctoral candidates who receive funding as GSRs through research grants. Of these, approximately 6,000 work on federal research grants. The work performed by GSRs on these grants is conducted under the direction of faculty members at one of the nine campuses in the university system.[7] In order to earn a doctoral degree, GSRs must conduct research activities related to their degree subject and prepare a written dissertation.

University officials told us that university policy limits GSRs to a maximum appointment level of 50 percent (20 hours per week) during the academic year (9 months) and 100 percent (40 hours per week) during the nonacademic periods (3 months). GSR appointments are limited by the availability of funds, and most appointments are for less than the maximum level. For their work, GSRs receive a salary and tuition and/or fee remission from the university. In the fiscal years 1996 through 1998, the university charged approximately $201 million to federal research grants for GSR compensation.

[6]The University of California also receives research grant funds from the state and private and corporate donors. In fiscal year 1997, the university received $284 million in state funds and $314 million from private and corporate donors for university research.

[7]The University of California has campuses at Berkeley, Davis, Irvine, Los Angeles, Riverside, San Diego, San Francisco, Santa Barbara, and Santa Cruz.

The salary GSRs receive depends upon the number of hours they work and the course of study. According to university officials, most GSRs are appointed to federal research grants after completing the first year of a doctoral program; and most of these are compensated at the step II or higher GSR salary level, which ranges from $13.40 per hour to $18.65 per hour.

The tuition and fee remission portion of the compensation paid to GSRs is based on the residency status of the student and the level of appointment. GSRs who are foreign, nonresident aliens receive up to $14,500 per year in tuition and fee remission—the amount of tuition and fees charged nonresident citizens at the university. GSRs who are California residents, on the other hand, receive up to $4,400 per year in fee remission, which is the fee charged residents.[8] GSRs having an appointment level of less than 25 percent receive no fee and/or tuition remission benefits. GSRs who are working on a part-time basis—25 to 44 percent of the time—receive up to 50-percent remissions; and those who are on appointments of 45 to 50 percent receive up to 100-percent remissions.

We reviewed the compensation paid to GSRs assigned to federally funded grants at the university to determine if the compensation was reasonable. Because OMB Circular No. A-21 does not provide clear guidance regarding reasonable compensation for graduate students, we therefore compared the total compensation paid to individual GSRs against the NIH guideline establishing an award level of $23,000 per GSR and the salary paid to a first-level postdoctoral researcher at the university performing comparable work at an equivalent level of effort.[9]

Using the NIH standard of $23,000 per GSR, we reviewed the compensation paid to GSRs assigned to federally funded grants for 3 school years—1995-96, 1996-97, and 1997-98—for all campuses of the university. We found that 6.5 percent, or 1,194 GSRs out of 18,389, received compensation in excess of $23,000 per GSR for those years. Furthermore, out of a total of $201 million charged by the university to federally sponsored research,

[8]California residents are not charged tuition. Depending upon the appointment level, non-California residents are charged both fees and tuition. The fees include educational fees, registration fees, and other charges depending on the campus and program of enrollment.

[9]For a brief period of our review, the fall semester of 1995, the $23,000 figure had not been established by NIH.

$4.4 million was charged in what we believe to be unreasonable compensation. Table 1 details our findings.

Table 1: Compensation Above NIH Standard in Federal Dollars for School Years 1995-96, 1996-97, and 1997-98

	1995-96	1996-97	1997-98	Totals
GSRs working on federal research projects	6,213	6,108	6,068	**18,389**
GSRs exceeding $23,000	369	370	455	**1,194**
Total compensation in federal dollars	$67 million	$67 million	$67 million	**$201 million**
GSR compensation that exceeded $23,000	$1.4 million	$1.4 million	$1.6 million	**$4.4 million**

We also reviewed a May 1997 GSR compensation report that the university prepared for the HHS Inspector General, covering approximately 2,556 GSRs working on federally funded research grants at three of its campuses—Berkeley, Davis, and Los Angeles—for the 1995-96 academic year. The report showed that 202 GSRs had received compensation in excess of the $23,000 NIH standard. This represented approximately 8 percent of the total GSRs for the covered period. The three campuses received over $625,000 in reimbursements that exceeded the NIH guidelines for these students' compensation.

In addition, we reviewed individual student compensation for calendar year 1997 NIH-approved grants at the Berkeley campus and found that 14 of the 408 GSRs, or 3.4 percent, had exceeded the NIH standard of $23,000. The university charged federally sponsored research $43,126 in excess of the NIH standard for these students' compensation. The total reimbursement at the Berkeley campus for calendar year 1997 was $3,384,580. In one case, a GSR received over $35,000 in compensation that was charged to federal grants.

We also compared the compensation paid to GSRs assigned to federally sponsored research projects to the salary received by a first-level postdoctoral researcher performing comparable work at the same level of effort at the university. We found that during school years 1995-96 through 1997-98, the hourly rate for GSRs at the first level ranged from $12.45 to $12.95 per hour. However, most GSRs were compensated above the first

level and received a salary from $13.40 to $18.65 per hour for the same period. The hourly rate for a first-level postdoctoral researcher was $12.98 to $13.72 for the same period. Furthermore, while most GSRs received either fee or fee and tuition remission, which could range between $4,400 and $14,500 per GSR, postdoctoral researchers received no remissions.

Table 2 sets forth the compensation that a GSR at the step II salary level would have earned at the university, assuming the maximum level of effort, i.e., a 50-percent level of effort during the academic period and a 100-percent level of effort during the nonacademic period. The compensation paid to a first-level postdoctoral researcher performing comparable work at the same level of effort is also set forth below.

Table 2: Compensation for Step II GSRs and First-Level Postdoctoral Researchers

Academic school year	GSR step II salary only	GSR step II salary with fee remission	GSR step II salary with fee and tuition remission	First-level postdoctoral researcher compensation
1995-96	$17,490	$22,123	$29,822	$17,138
1996-97	$17,843	$22,508	$30,857	$17,483
1997-98	$18,203	$22,925	$31,909	$17,835

Based on our analysis of University of California data, we found that during the 3 school years 1995-96, 1996-97, and 1997-98, 4,386 GSRs out of 18,389, about 24 percent, received compensation that exceeded the compensation paid to a first-level postdoctoral researcher performing comparable work at the same level of effort.[10] The university charged federally sponsored research $19.3 million for these students' compensation in excess of what it paid first-level postdoctoral researchers at a comparable level of work and effort.

The university asserts that it complied with OMB requirements because the salary and tuition and/or fee remission constituted reasonable compensation for the work performed and was conditional upon the performance of necessary work. However, in a February 22, 1995, internal memorandum to the university's Senior Vice President for Business and Finance, the Director of Resources and Administration made the following

[10]Sufficient data were not available to compute the proper compensation amounts for those GSRs who had less than maximum appointments.

comments on the 1994 HHS audit report concerning the allowability of fee and tuition payments as costs chargeable to federal research grants.

"Had the audit taken place at UCLA [University of California at Los Angeles], the auditors may well have questioned the reasonableness of our policies and procedures. In most if not all instances the total compensation paid to UC [University of California] graduate students employed on research projects will substantially exceed the published salary for entry-level postdoctoral researchers working at the same level of effort. The current salary scale for graduate students, depending on the specific job title used, is either slightly below or identical with the salary scale for postdoctoral researchers. Graduate students working in research are also eligible for tuition and/or fee remission, not available to postdoctoral researchers, with an equivalent value ranging from $1,866 to $12,089 annually.

"Paragraph J.41 of Circular A-21 states that 'tuition remission and other forms of compensation paid as or in lieu of wages to students performing necessary work are allowable...(emphasis added).' The underlined language raises two additional issues about UC's tuition and fee remission programs. First, for the six campuses with a tuition remission program, non-residency status increases the graduate student researcher's total compensation by $7,699 above that paid to residents in the same job title and step. This may support a finding that tuition remission at UC is paid as a fringe benefit or as student aid, rather than paid 'as, or in lieu of,' salaries and wages. Second the University does not withhold income tax on the value of tuition and fee remission. This accounting treatment may further support a finding that such charges are not being paid as, or in lieu of, wages."

Foreign GSRs and Tuition Remission Funds

While the salary was proportionally the same for resident and foreign GSRs during school years 1995-96 through 1997-98, foreign GSRs received a larger proportionate share of the total tuition and fee remission costs charged against federal grants than did resident GSRs. This resulted because of the university's policy to provide nonresident tuition remission to foreign students and include the amounts as part of the GSR compensation charged to the federal grants for nonresident GSRs.

Neither OMB nor HHS provides educational institutions with clear guidance on whether out-of-state tuition costs should be passed on to the federal government. However, in reviewing an internal university document prepared in 1996, we noted that the university had found that no other public universities charged the cost of out-of-state tuition to federal grants. We also noted that the state of California does not allow the university to charge state grant awards for nonresident tuition remission. Similar policies have been established by several major private research foundations.

Although foreign GSRs comprised 21 to 24 percent of the total GSRs at the university for the school years 1995-96 through 1997-98, they received 34 to

38 percent of the tuition and fee remission moneys in those years. Foreign student GSRs were compensated at a higher level because their nonresident status made their tuition and fee remission approximately $7,700 higher than that of resident GSRs performing the same work in 1995-96, approximately $8,400 higher in 1996-97, and $9,000 higher in 1997-98. The tuition remission awards to resident and foreign GSRs assigned to federally funded grants were distributed as illustrated in table 3.

Table 3: Tuition Remission Received by GSRs Assigned to Federally Funded Grants

	Resident[a]				Foreign			
School year	Number of GSRs	Percent of GSR population	Fee remission funds (in millions)	Percent of funds	Number of GSRs	Percent of GSR population	Tuition and fee remission funds (in millions)	Percent of funds
1995-96	3,402	79	$7.9	65	887	21	$4.3	35
1996-97	3,278	79	$8.4	66	868	21	$4.4	34
1997-98	3,366	76	$8.4	62	1,090	24	$5.2	38

[a] "Resident" includes 4 percent of GSRs who are U.S. citizens and/or resident aliens but are not California state residents. University policy precludes these GSRs from receiving nonresident tuition benefits beyond 1 year's attendance.

GSR Compensation and the Internal Revenue Code

Although the university treats GSRs' salary and tuition and/or fee remission as compensation for purposes of the OMB circular, traditionally the university has treated only the salaries as part of the GSRs' gross income subject to federal income tax. Therefore, the university has not treated the tuition and/or fee remissions as part of the GSRs' gross income subject to federal income tax. The university cites section 117 of the Internal Revenue Code (26 U.S.C. section 117) as its authority for not considering the tuition and fee remission as part of the GSRs' gross income.

Section 117(a) of the Code excludes from certain individuals' gross income qualified scholarships and tuition remission. Subsections 117(d)(2) and (d)(5)[4] indicate that a qualified tuition remission or reduction is the amount of any reduction in tuition provided to an employee of an organization, such as the university, for the education of the individual at the undergraduate level or at the graduate level if the employee is engaged in teaching or research activities. The exclusion from gross income for scholarships and tuition remission is limited, however, by subsection 117(c), which provides that the exclusion does not apply to that portion of

any amount received by a student that represents payment for teaching, research, or other services by the student required as a condition for receiving the scholarship or tuition remission.

On July 13, 1998, we wrote IRS and requested its views on whether the university could exclude tuition remission from gross income even though the remission is treated as reasonable compensation for purposes of OMB Circular No. A-21. IRS replied to our request on January 6, 1999. (See app. I.)

In its letter, IRS recognized that under reimbursement guidelines set forth in OMB Circular No. A-21, universities are allowed to recover the costs of compensation for personal services incurred in carrying out sponsored research programs, including amounts expended for wages and fringe benefits, provided such amounts represent reasonable compensation. It also recognized that expenses for tuition or tuition remission are allowed in certain circumstances. On the other hand, IRS noted that for tax purposes, the grantors may not treat the scholarship amounts as includable in the recipients' gross incomes or otherwise regard the payments as compensatory scholarships. IRS did not, however, view these positions as necessarily inconsistent. It explained, "[C]ircular A-21 has no effect on the proper federal income tax treatment of any amount paid an employee or student, nor would an employer's claim for reimbursement from the government for amounts paid to students have any effect on a particular student's tax liability." Instead, IRS stated that the "tax consequences of any amount paid a student or employee are determined by the particular facts and circumstances attendant to the particular grant or payments to the student, and not by any employer reimbursement claims."

To ensure that we fully understood IRS's position, we spoke with a Senior Attorney in IRS's Office of Chief Counsel. He informed us that a reasonable tuition remission provided as a result of an employer-employee relationship could properly be considered as an employee fringe benefit and excludable from the employee's gross income for tax purposes. The information provided by the Senior Attorney and in the IRS letter was general in nature and did not apply to any particular individual or university.

In view of IRS comments on this matter, it would be difficult for us to reach any conclusion as to the proper tax treatment of the tuition remission provided to GSRs by the University of California. Similarly, we refrain from taking any position with respect to whether the exclusion of GSRs' tuition remission from gross income is inconsistent with the treatment accorded

such remissions under OMB Circular No. A-21. In this regard, we note that both HHS and NIH officials told us that in determining whether tuition remission is allowable under a grant, they pay no attention to the taxability issue. Insofar as the university's treatment of tuition remission as nontaxable compensation for income tax purposes, HHS and NIH stated that they believe this is an IRS issue, which has no bearing on whether GSRs' compensation is reasonable under the OMB circular. HHS and NIH officials added that since the number of paid hours worked is controlled by the university and students report spending many additional hours on the grant's work, tuition remission could be considered compensation for these added hours.

Furthermore, in a qui tam case pending in the United States District Court of California, the relator has alleged that the University of California violated the False Claims Act by, among other things, knowingly charging to government-sponsored research projects numerous payments to graduate students that were unallowable under OMB Circular No. A-21. In support of this allegation, the relator has alleged that the university knowingly failed to disclose to the government that it had excluded from gross income, under 26 U.S.C. section 117, tuition remission received by its graduate students for work on federally sponsored research grants. The decision in this case may have a bearing on whether the university's treatment of the tuition remission for tax purposes is inconsistent with the OMB circular. This constitutes an additional reason why we do not believe it would be appropriate for us to address this issue.

Grant Management and HHS Oversight Issues

HHS is the cognizant audit agency for the University of California. Routinely, HHS does not conduct preaward or postaward audits. When requested to conduct audits for awarding agencies other than NIH, it examines the total aggregate amounts for each line item to ensure that the institution has not exceeded the amounts approved by the awarding agency. With respect to NIH awards, it follows the same action except with regard to the specific costs involving GSR compensation. For these costs, it ensures that the institution has not requested GSR compensation that would exceed the NIH cap of $23,000 (currently $26,000) per GSR identified in the request. HHS officials rely on the Sponsored Projects Office at the institution to ensure that the compensation is reasonable and has not exceeded what the institution would have paid a first-year postdoctoral researcher working at the same level of effort as the GSR.

Scope and Methodology

We conducted our investigation from May 1998 to May 1999. We reviewed University of California administrative and GSR records and interviewed administrative staff, faculty, and GSRs at five campus locations—Berkeley, Irvine, Los Angeles, San Diego, and San Francisco. We also reviewed documents at OMB, HHS, NIH, and the IRS and interviewed cognizant officials at these agencies. We did not conduct an audit of GSRs or independently verify information provided to us by the University of California.

As agreed with your office, unless you announce its contents earlier, we plan no further distribution of this report until 30 days after the date of this letter. At that time we will send copies of the report to the Honorable Donna E. Shalala, Secretary of Health and Human Services and to the Regents of the University of California. We will also make copies available to others upon request. If you have any questions concerning this report, please contact me or Assistant Director Stephen Iannucci at (202) 512-6722.

Sincerely yours,

Robert H. Hast
Acting Assistant Comptroller General
for Special Investigations

January 6, 1999, IRS Letter

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

JAN 6 1999

Kevin P. Craddock, Special Agent
Office of Special Investigations
United States General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Craddock:

This is in response to your July 13, 1998, correspondence to Michael Danilack, Associate Chief Counsel (International), concerning tax issues relating to federal research grant funds. Specifically, you inquired about the proper federal income tax treatment of certain scholarship grants and qualified tuition reductions under section 117 of the Internal Revenue Code (Code). Because this office, the Office of the Assistant Chief Counsel (Income Tax and Accounting), has primary jurisdiction over the treatment of grants falling within the purview of section 117, the response to your inquiry has been prepared by our office, after coordination and consultation with other affected Internal Revenue Service functions.

In your inquiry, you indicate that you are investigating the possible misuse of federal funds that are used to reimburse colleges and universities for monies spent on approved government research contracts. It is our understanding that under established government (Office of Management and Budget (OMB)) guidelines, educational institutions performing government research contracts and administering government sponsored grants are permitted to recover certain costs associated with the projects. The general guidelines governing reimbursement of allowable costs are contained in Section J of Circular A-21, Cost Principles for Educational Institutions (the Circular) (copy of relevant pages enclosed).

Under these guidelines, it appears that educational institutions are generally allowed to recover from the government the costs of compensation for personal services incurred in carrying out sponsored research programs, including amounts expended for salaries, wages, and fringe benefits, to the extent such amounts represent reasonable compensation within the scope of section J.8 of the Circular. Under section J.8.f (2), expenses incurred for tuition or remission of tuition for individual employees are allowed, provided such benefits are granted in accordance with established educational institutional policies, and are distributed to all institutional activities on an equitable basis.

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Section J.41 of the Circular provides rules respecting reimbursements for scholarships and other forms of student aid costs. In general, scholarships and tuition remission expenses are **not** allowable costs, unless such expenses represent compensation for services, i.e., are paid as, or in lieu of, wages to students performing necessary project work, and certain other considerations are satisfied.

The information you have received suggests that some colleges and universities may be improperly seeking reimbursement from the government for the costs of noncompensatory payments to graduate teaching and research assistants. You asked for our technical assistance regarding the proper characterization of amounts as "scholarships" and "qualified tuition reductions," and also raised a number of specific questions regarding the proper federal tax treatment of such amounts.

We are pleased to provide the following general information and comments, which we hope will be of help to you in determining whether colleges and universities are properly complying with the guidelines applicable to federal grant fund reimbursements. Of course, we express no opinion as to the tax liability of any particular taxpayer or the tax effect of any particular transaction, and we express no opinion as to the qualification or propriety of any reimbursement claim under Circular A-21.

Section 61(a) of the Code provides that, except as otherwise provided in subtitle A, gross income includes all income from whatever source derived, including, but not limited to, compensation for services, fees, commissions, fringe benefits, and similar items.

Section 117 of the Code, however, provides special rules for the treatment of both "qualified scholarship and fellowship grants," and "qualified tuition reductions," as described therein.

With respect to the federal income tax treatment of scholarship and fellowship grants, section 117(a) provides, generally, that gross income does not include any amount received as a qualified scholarship or fellowship grant by an individual who is a candidate for a degree at an educational organization described in section 170(b)(1)(A)(ii) (describing, generally, a school).

Generally, a scholarship or fellowship grant is any amount paid or allowed to, or for the benefit of, an individual to aid such individual in the pursuit of study or research, whether at the undergraduate or graduate level. To be considered a scholarship or fellowship grant, an amount need not be formally designated as such. For example, a scholarship may take the form of a tuition reduction or remission.

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Only "qualified scholarships" may be excluded from income. A qualified scholarship is defined as an amount expended for "qualified tuition and related expenses" as defined in section 117(b)(2) (including, generally, fees, books, supplies and required equipment).

Section 117(c) of the Code, implementing changes made by the Tax Reform Act of 1986 (the Act), Pub. L. No. 99-514, provides that the exclusion for qualified scholarships and fellowship grants shall not apply to that portion of any amount received which represents payment for teaching, research, or other services by the student required as a condition for receiving the qualified scholarship or fellowship.

Section 117 of the Code also provides an exclusion from gross income for the amount of any "qualified tuition reduction."

Generally, amounts paid to or for the benefit of employees are presumptively compensatory in nature, and ordinarily includible in gross income as wages. Section 117(d)(1), however, provides a special rule in the case of a "qualified tuition reduction," stating that gross income shall not include any qualified tuition reduction.

Section 117(d)(2) defines a qualified tuition reduction as the amount of any reduction in tuition provided to an employee of a section 170(b)(1)(A)(ii) educational organization for the education (below the graduate level) at such an educational organization, of (A) such employee, or (B) any person treated as an employee (or whose use is treated as an employee use) under the rules of section 132(h) of the Code (section 132(h) refers, generally, to spouses and dependent children of current and retired employees).

Section 117(d)(5)[4] provides that, in the case of an individual who is a graduate student at an educational organization described in section 170(b)(1)(A)(ii) and who is engaged in teaching or research activities for such organization, section 117(d)(2) shall be applied as if it did not contain the phrase "below the graduate level." Thus, an individual who is a graduate student at a qualified educational institution (college or university) and who is engaged in performing teaching or research activities for such organization, is a permissible employee recipient of a "qualified tuition reduction" under section 117(d)(2).

As in the case of scholarship and fellowship grants excludible under section 117(a), the exclusion provided under section 117(d) for "qualified tuition reductions" is subject to the compensation limitations of section 117(c), mentioned above. Because of this limitation, only amounts beyond those

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representing reasonable compensation for services may be excluded from gross income under section 117 generally.

Where only a portion of an overall award paid to or on behalf of an individual represents compensation for services, the grantor must make a good faith determination of the amount to be allocated to payment for services, and the amount of the scholarship or tuition reduction. This determination is inherently factual. However, factors considered by the Service as relevant in making this allocation include: the amount paid by the grantor for similar services performed by students with qualifications comparable to those of the scholarship recipient, but who do not receive scholarships or tuition reductions; amounts paid by the grantor for similar services performed by full-time or part-time employees of the grantor who are not students; and amounts paid by employer educational institutions other than the grantor for similar services performed either by students or other employees.

If the recipient includes in gross income an amount properly allocated by the educational institution grantor as reasonable compensation for services, any additional amount of a scholarship, fellowship stipend, or tuition reduction received from that grantor is eligible for exclusion under section 117. By way of example, if a student receives a tuition reduction valued at $15,000 and cash stipend payments of $13,000 during a year, and as a condition of receiving the payments is required to perform teaching, research, or other services the reasonable value of which is $13,000, then the $15,000 amount may be excluded from income either as a qualified scholarship under section 117(a) or, if the requirements of section 117(d) are met, as a qualified tuition reduction.

Continuing our example, the $13,000 compensatory amount would be includible in gross income, subject to income tax withholding, and reportable on Form W-2. The application of FICA and FUTA would depend upon the nature of the employment, the status of the employer organization, and the existence of any exclusions. However, we note that most graduate teaching and research assistants (students) would likely qualify for the exemption from FICA taxes provided for in section 3121(b)(10) of the Code, and that most educational institution grantors, exempt from federal income tax under section 501(c)(3) of the Code, would also be exempt from the application of FUTA.

The $15,000 tuition reduction amount would not be regarded as compensation for services under section 117, and would not be subject to either information reporting or withholding. In the case of domestic students, unless a scholarship grant is subject to section 117(c), i.e., is a compensatory grant for federal income tax purposes, there would be no information reporting requirements or withholding obligations imposed upon the grantor

with respect thereto. See Notice 87-31, 1987-1 C.B. 475, a copy of which is also enclosed.

The rules discussed above generally apply to nonresident alien students and researchers, but may be modified under income tax treaties between the United States and another country. Thus, amounts that are exempt from taxation under section 117 of the Code paid to a U.S. citizen or resident are also exempt from taxation if paid to nonresident alien individuals. Scholarships or grants that are not exempt under section 117 are subject to taxation. If the scholarship or grant amount is incidental to a qualified scholarship to which section 117(a) applies, the amount is generally subject to withholding at a rate of 14 percent (or lower rate if the procedures of Rev. Proc. 88-24 are used) to the extent includible in gross income. Sections 871(c) and 1441(b). The tax on scholarship or grant income may, however, be eliminated under an income tax treaty. If scholarships or grants are excluded from gross income under section 117, they are not subject to reporting. However, if they are not subject to tax by virtue of an income tax treaty, they are subject to reporting on Form 1042-S. Section 1.1461-2.

Amounts paid to nonresident aliens as compensation for services are not treated as scholarships or grants. Such compensation income is subject to withholding and tax. Sections 864(b) and (c); section 872. Some income tax treaties, however, exempt compensation from taxation if the payments meet the criteria of either a student/trainee article or a teacher/researcher article. The student article of some income tax treaties exempt compensation from taxation if the compensation does not exceed a certain amount, generally between $2,000 and $5,000. The student article generally limits benefits to a certain time period, such as 5 years. The teacher/researcher article of some treaties exempts compensation paid to teachers, professors, and researchers. The exemption from taxation of compensation under a teacher/researcher article is generally not limited in amount but is limited to a specified time period, typically two years.

Finally, all treaties include articles, generally called dependent personal services and independent personal services, that exempt compensation income. However, we do not believe that these articles will generally apply to the facts you have described. You may obtain more information regarding student and teacher/researcher articles of income tax treaties by referring to Publication 901, U.S. Tax Treaties (copy also enclosed).

Amounts paid to a nonresident alien that represent compensation for services, whether or not exempted from tax under an income tax treaty, are subject to reporting. If the nonresident alien student or researcher is an employee, the

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income is generally reported on Form W-2. If, however, employee compensation is exempt from taxation under a treaty, it will be reported on Form 1042-S. Forms 1042-S use a specific income code for income reported as compensation.

Applying the above principles to the issues you raise, we think some confusion may exist over the intended meaning of the term "compensation for services." Under the reimbursement guidelines, educational institutions are generally allowed to recover the costs of compensation for personal services, including amounts spent for certain fringe benefits, including tuition or remission of tuition, but may not recover amounts spent for scholarships, unless the scholarships are compensatory.

The matter you referred for our consideration does not appear to involve reimbursement claims for "scholarships" within the meaning of section 117(a) of the Code, since only "compensatory" scholarships, paid in lieu of salary or wages, are allowable under section J.41 of Circular A-21. Such amounts, being described in section 117(c), would be includible in recipients' gross incomes as "wages" under Notice 87-31. Additionally, the grantors of such amounts would be subject to certain withholding and reporting requirements respecting wages, including withholding for income taxes and the filing of Forms W-2. We understand that the grantors seeking the reimbursements at issue here do **not** treat the amounts as includible in recipients' gross incomes, or otherwise regard the payments as compensatory scholarships.

As we earlier indicated, amounts paid to employees are presumptively compensatory and includible in gross income for tax purposes. However, the Code contains exceptions to this general rule, and not all payments to or for the benefit of employees are subject to income and employment taxes. Section 127 for example, provides an exclusion for certain amounts paid under qualified employee assistance programs, while section 132 excludes from employees' gross incomes the value of a number of fringe benefits described therein. Similarly, section 117(d) creates a special rule for certain payments to the employees of educational institutions, including graduate teaching and research assistants, permitting an exclusion for income and employment tax purposes for qualified tuition reductions, amounts that clearly are paid by reason of the employment relationship, and that clearly would otherwise constitute additional, includible compensation to such employees in the absence of the statute.

Although defined in section 117 of the Code, and subject to the compensation considerations applicable to scholarships, a qualified tuition reduction is **not** a scholarship or fellowship grant, but rather an employee fringe benefit which is statutorily

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excludible from an employee's gross income. (We note that the exclusion for graduate level tuition reductions for teaching and research assistants was previously located in section 127(c)(8) of the Code, a provision relating to employee assistance programs, before its relocation to section 117(d)).

In this context, we believe educational institution employers, e.g., colleges and universities, are likely to view a section 117 tuition reduction benefit as a fringe benefit not unlike other fringe benefits, and part of their overall employee compensation package, albeit excludible compensation for federal income and employment tax purposes. Presumably, reimbursement for the costs of this benefit would be claimed under section J.8.f (2) of the Circular rather than section J.41.

Of course, we express no opinion as to whether tuition reductions for graduate teaching and research assistants were intended to, or in fact, fall within the purview of reimbursable expenses referred to in section J.8.f (2) of Circular A-21, or whether such amounts were intended to be addressed exclusively in section J.41 of the Circular. However, we note that the penultimate sentence of section J.8.f (2), referencing the limitation on benefits for family members, suggests that section 117(d) benefits are within the scope of the section.

You also raised a number of specific questions relating to a university's payment of qualified tuition reduction benefits to limited numbers of resident and non-resident graduate teaching and research assistants. In the situations you posit, the amounts appear to constitute excludible benefits under section 117(d) of the Code. In general, the amount of the reduction in tuition is of no consequence under section 117; the important consideration is the amount representing reasonable compensation, which must be included in income. Amounts in excess of reasonable compensation are excludible, notwithstanding differences in the amounts of tuition among various classes of students. As discussed earlier herein, there are no reporting or withholding obligations for noncompensatory scholarships or qualified tuition reductions. Circular A-21 has no effect on the proper federal income tax treatment of any amount paid an employee or student, nor would an employer's claim for reimbursement from the government for amounts paid to students have any effect on a particular student's tax liability. The tax consequences of any amount paid a student or employee are determined by the particular facts and circumstances attendant the particular grant or payment to the student, and not by any employer reimbursement claim. A limited program of tuition reductions for particular graduate students does not violate any requirement of section 117(d) (we express no opinion as to whether such a restriction violates section J.8.f (2) of Circular A-21)). Lastly, a high number of non-resident or foreign benefit recipients has no consequence under section 117(a) or 117(d).

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Thank you for soliciting our views in this matter. I apologize for the delay in responding to your inquiry and hope that this delay did not cause you any inconvenience. If we may be of further assistance, or if additional information is needed from this office, please do not hesitate to contact William Jackson or Michael Schmit of my staff, at (202) 622-4960.

Sincerely yours,

Irwin A. Leib
Deputy Assistant Chief Counsel
(Income Tax and Accounting)

Enclosures:
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